LESSONS FROM THE BANK OF ENGLAND[1]

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IN discussing the Bank of England it is necessary first to state the essential facts of its history. Until 1797 it was operated very much as the Bank of France has been during the last hundred years, issuing bank notes and accepting deposits practically without regulation and restriction. But in 1797, because England was losing gold under the influence of the expenditures made by the government abroad, the bank was restricted from redeeming its notes. Then began a chaotic period in English finance, very much like that which existed in this country from 1862 to 1878, a period of irredeemable paper money, the notes of the Bank of England constituting the standard of prices throughout the United Kingdom. The situation became so serious that finally, in 1810, the celebrated Bullion Committee rendered its report, attributing the premium on gold to the excessive issue of bank notes. The bankers and business men of England at that time, as a rule, were inclined to think that the premium on gold was due, not to any depreciation of bank notes, but to the machinations of a foreign enemy, to an unnatural increase in the demand for gold.

During that period, of course, the Bank of England note became a legal tender. Specie payments were resumed in 1821. Shortly thereafter joint-stock banks were organized which began to issue notes, using the Bank of England notes as their reserve, for they were still legal tender. Then began the development in England of a credit system superimposed upon another credit system. England suffered the same industrial and financial reverses in the '30's as this country and there was the same debate that we had with regard to the necessity for

[1] A paper presented at the meeting of the Academy of Political Science, Nov. 11, 1910.

properly securing the issue of bank notes and with regard to the danger to a country arising from an over-issue of bank notes. The so-called currency party, which advocated the idea that all bank notes should be based sovereign for sovereign upon gold, triumphed, and by the bank act of 1844, the Bank of England was deprived of its power to issue notes except in exchange for gold, with the exception of £13,000,000 already outstanding, which were covered by government securities. Since then the bank has taken over the issue of certain country banks, so that now this issue of notes not covered by gold amounts to about £18,500,000. It is unable to issue further notes except in exchange for gold, and that gold is not held in the reserve of its banking department, but is set on one side in a so-called issue department, where it is held in trust for the holders of the notes. Consequently a large part of the gold held by the Bank of England does not belong in any sense to the depositors or the general creditors of the bank, any more than the gold in the United States Treasury held as security for the gold certificates can be utilized in this country for the redemption of our greenbacks.

These are the fundamental facts leading up to the act of 1844, an act which is responsible for a great loss to England's trade and industry. Most Englishmen are opportunists in finance; they do not think things out in advance as do the French or the Germans, but wait until trouble is near and then do something to escape damage. Three years after the act of 1844 was passed, the panic of 1847 occurred, and it was necessary to suspend the bank act and permit the bank to issue notes without regard to the requirement that they should be issued only in exchange for gold. In other words, the banking department was permitted to obtain notes from the issue department by the deposit of securities. The same thing happened in 1857, and again in 1866. It might have happened since then had not a strong neighbor across the Channel come to the relief of the English money market in critical periods.

Prior to 1844, when the banks had freedom of issue, the English people employed bank notes in making exchanges very much as did the French and Germans, or as the French and

Germans do to-day. So did we at that time, but it was held prior to 1844 that the bank note contained something essentially dangerous and that an over-issue of notes would cause a crisis to arise and gold to be exported. It did not seem to occur to many of the disputants of the time, that deposits, or deposit credits, might be so developed that an over-issue of such credits would with equal suddenness or certainty cause a rise of prices and an expulsion of gold. That is something which has been learned since. The note credit is *per se* no more dangerous than the deposit credit, and the deposit credit is capable of a great deal more injury than the note because it is capable of much greater expansion, for there is a limit to the amount of paper money that we will carry or use, but there is apparently no limit to the amount of bank credit that we are willing to obtain and utilize through the medium of the check book.

Englishmen therefore began at once to develop the deposit credit and the use of the check book, until at the present time, if you will take the time to read the interesting interviews published by the National Monetary Commission,[1] interviews with the leading bankers of London, or to read the valuable monographs by Mr. Withers,[2] the financial editor of the London Times, and by Mr. Palgrave, you will discover that the practical bankers of England are almost a unit in the belief that the deposit currency which has been brought into existence since the act of 1844 was passed is wellnigh perfect, and that the English banking system as it exists today is the very best in the world. In the same interviews you will find very courteous but pointed criticisms of the French and German systems.

The act of 1844 compelled English finance from that time on to travel on its front legs, and as a result the hind legs shriveled and became unimportant, but the front legs developed

[1] *Interviews on the Banking & Currency Systems of England, France, Germany, Switzerland and Italy.* Washington, 1910. National Monetary Commission. (Senate doc. 405, 61st Cong., 2d sess.)

[2] *The English Banking System.* By H. Withers, R. H. I. Palgrave and others. Washington, 1910. National Monetary Commission. (Senate doc. 492, 61st Cong., 2d sess.)

tremendous muscles, and now if you go to England, and talk about the Bank of England and the English banking system, they will show you at once those gigantic front legs. No other country in the world has anything like them. Business is done everywhere by check, and check currency has vastly greater elasticity than have bank notes. The front legs have deen developed, and they are getting along very well in a state of stable equilibrium. In the writings and interviews of the English bankers the fact that London has become the financial and commercial center of the world is attributed to the excellence of the English banking system. England's position as the world's financial center is in reality due entirely to the fact that on account of her geographical position and on account of the remarkable characteristics of her people, she was first of all the world's trade center, she became the world's workshop, the island from which goods were sent to all corners of the globe, and to which were sent payments from all quarters of the globe. That is the reason why London has become the financial center of the world.

Now, a word about the value and importance of the check credit as compared with the note credit. England has built up a gigantic structure of deposit credit or deposit currency. It is entirely without its natural protector, the bank note; for a bank deposit is simply the bank's promise to pay to the depositor, and it is utilized by the check. English banks encouraged the use of checks even to the extent of crossing them, so that no man receiving one could go to the bank and get cash, a crossed check being payable only through the clearing house, as we would say. But the deposit credit is taken care of. Naturally if the recipient of a check desires a medium of exchange which everybody will take without endorsement he finds it in the bank note. The note then naturally takes the place of the check if the bank can issue notes, as the Bank of England cannot, because its notes are practically note certificates. Hence the Bank of England and all the bankers, relying upon its stability, encourage the use of checks and discourage the use of that other instrument of exchange which people in all countries excepting England and the United States employ. If notes

cannot be issued, then the bankers will discourage the use of notes and encourage the transaction of business by check. This goes on very well until something causes a certain amount of gold to be drawn from the banks either for domestic use or on account of international indebtedness. Now, the Bank of England, being unable to use notes to protect its credit when its cash reserve is encroached upon, is obliged to raise the rate of discount. When its discount is raised, other banks in England raise their rate, and every merchant, every manufacturer, every man in England using capital, is obliged to pay a higher rate of interest than he would have been obliged to pay had not the bank been afraid that it would lose some of that precious reserve which constitutes the sole protection of the great mass of bank deposits and deposit currency in the United Kingdom. If the raising of the rate does not cause gold to flow into the bank's vaults or prevent it from being withdrawn, then the bank goes into the open market and borrows money. It borrows, not gold, but credit, in order that it may raise the market rate of interest by depleting the supply of loanable funds. By thus lowering the price of sterling bills, it induces foreigners to invest a little more heavily in such securities, in this way bringing about a flow of gold toward London. That is a remarkable thing for a bank to have to do, in the first place to raise artificially its rate of interest, at least once a year and often several times, either to keep gold from going out or to draw some more gold in from abroad, and then to go still further and bid up the rate of interest by borrowing in the open market.

I am glad to see that the Englishmen who treat of that subject, Mr. Withers and Mr. Palgrave, both deplore this necessity and both perceive clearly the fact that the necessity for such unnatural banking has been orced upon the Bank of England by the situation developed as a necessary result of the act of 1844.

Mr. Palgrave, for instance, on page 261 of his monograph entitled *The English Banking System*, published by the Monetary Commission, says, "It is true that for more than forty years the government has not had occasion to sanction any suspension of the Peel Act, but the price which has had to

be paid for this has been an extremely high one, and the adoption of the arrangements of the Act of 1844 cannot be recommended to any other country." It is evident to any business man or banker that if a bank is artificially holding the rate of interest higher than would be the normal rate on capital, or in other words is raising the rate merely to draw gold into its reserve or to prevent gold from being drawn out of its reserve, the borrowers of the country are subject to harmful fluctuations in their costs, to uncertainties which tend to discourage the development of trade and industry. According to the statistics published by the Monetary Commission in regard to the banking and industrial affairs of Great Britain, France and Germany, during the last ten years the Bank of England has changed its rate 107 times, and the rate has varied from 2 to 7 %. During the same time the Bank of France, operated in the same way as the Bank of England before the act of 1844, has changed its rate only thirteen times, and the rate has fluctuated between 2 and 4½ % instead of between 2 and 7 %. The Bank of Germany, which has a restriction upon note issues changed its rate 73 times during the same period, the rate varying from 3 to 7½ %. Sometimes the condition was good, and sometimes it was bad. But the Bank of France, from my point of view, appears to have given the industries of France a rate of interest corresponding very nearly to what the economists call the rate of interest on capital, not a rate of discount fluctuating on account of temporary apprehensions with regard to a banking reserve.

The Bank of England has made little growth in the last twenty years. Its deposits were no larger in 1909 than they were fourteen or fifteen years ago, though the average of recent years is a little higher. The growth of the bank is shown by these figures: Deposits in 1880, £33,000,000; in 1909, £54,000,000. Notes outstanding in 1880, £26,000,000; in 1909, £29,000,000. Total liabilities in 1880, £60,000,000; in 1909, £83,000,000. Its resources have increased but 39 % in thirty years. On account of losing its relative importance in the money market, the bank has had to borrow money frequently in order to make its rate effective, thus working injury

to English trade in order to protect its own reserve. It is obliged to do it by the law of 1844 and by the system which has grown up under that law. I assume that these changes in the Bank of England rate, these artificial interferences with the money market of London, affect the prices of all loans and discounts in the United Kingdom. The resulting loss I figure at not less than ½ of 1 % on their deposit currency, which would amount to at least $35,000,000 per annum. I am inclined to think these figures too small. To say that England, for the maintenance of her present banking system, is unconsciously paying an annual tax of $35,000,000, I certainly think is putting the estimate too low.

But the English system has also some good features from which we may learn a lesson. First of all is the fact that England has a centralized reserve. All of England's banking reserve lies in the vault of one institution. That institution is not permitted by law to make a business use of it, and hence has not been able to grow. There has been no increase in the number of the bank's branches, and practically none in the amount of its business in spite of the great development of banking and of business in England and in spite of the rise in prices which naturally would have increased the numerical size of the items. England's financial system has weathered the storms in the past because the reserve has been under the control of practical, intelligent men, and they have jealously guarded it. Without dreaming that they were doing it, however, they have been obliged to impose a heavy tax upon English industry and trade in order to preserve the stability of the system. They have been able to maintain that stability because the reserve of only $150,000,000 was centralized and wisely managed. Even of this small reserve only a part was available for the protection of deposits, the rest being set aside and trusteed for the note holders. Despite these facts the centralization of the reserve and the resulting confidence in the institution, hampered as it is, have made it possible for England to finance her great enterprises without serious disaster.

Another good feature of the English banking system is the fact that the law, excepting the bank act of 1844, does not

seriously hamper any of the banking institutions. The Bank of England increases its deposits, its capital and its surplus at will. The law is silent with regard to the reserve that it must carry as a protection for its depositors, and with regard to the amount o its surplus and that of other banks.

On the other hand there are a number of bad features of the system from which we may take lessons. The law fails to provide a proper degree of publicity, a thing which instead of hampering the banks would undoubtedly increase their strength. Though they know that very well themselves, the bankers are not eager for a change in the law. The statements of English banks are exceedingly unsatisfactory, when one wants to know exactly what the condition of the bank is. For instance, they have in England deposit accounts and current accounts, and there is no way of finding out what are deposits and what are current accounts. The banks lend money on collateral and also on discount bills, thus disposing of their customers' money in two entirely different ways. When a bank is lending money on collateral, as the Bank of England and all the joint-stock banks in London do, then that bank is doing something tantamount to the advancing of funds for permanent investment. It is assisting in the construction of a railroad or in the building of factories, and that, of course, is a disposition of bank funds which cannot be approved. Even bankers themselves do not generally understand that there is always danger when they lend money on collateral, that the money is going, not into trade and industry, but into a permanent fixed form from which its rescue may be difficult. There is no way of telling how much money is advanced by the English banks on collateral and how much on discounts.

There is still a third point. The Bank of England's gold reserve, as previously stated, is exceedingly small, only about $150,000,000. If that reserve were $300,000,000, the bank would not be so nervous as at present with regard to a slight exportation of gold. Granting that the bank act of 1844 is to continue in force—and I imagine that it will continue in force for an indefinite period—the English people, or perhaps their government, must take some steps to accumulate in London a larger

stock of gold. The Bank of England might do so without cost to itself if the law permitted it to issue one-pound notes. Now the lowest note is five pounds. If the bank could issue one and two-pound notes and simply hold the gold, gradually the English people would become accustomed to these one and two-pound notes, and the gold now in circulation would flow into the bank. There is no reason why it should be exported to France or to the United States. The Bank of England under the law would be expected to hold that gold, and so it would get into circulation a large quantity of paper which would never come back for redemption. Thus it might increase its reserve by possibly fifty or seventy-five million dollars in the course of the next few years, although this amount is a mere guess.

My final criticism is this, that the Bank of England has been able to withstand the period of critical years since 1866 only because the Bank of France and other European friends with their larger hoards have usually been able and willing to help. If anything happens—and we all hope it never will happen—that Great Britain should get into war with another great nation, and if the English people should begin to get alarmed about an invasion, I think that a great many people who hold English sterling bills or who have bank accounts in London would be considerably worried until they had realized on their bills, and drawn as much gold as possible out of London. If that situation should arise, with the English finances in their present very delicate and unstable condition, the result might be disastrous.